

Internal Revenue Service
memorandum

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Brl:JCAlbro

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to: District Counsel, Boston CC:BOS
Attn: David Brodsky, Special Trial Attorney

from: Director, Tax Litigation Division CC:TL

subject: [REDACTED]

This is in response to your request for our comments regarding two memoranda submitted by [REDACTED] and [REDACTED] on issues concerning customer deposits.

ISSUES

1. Are the customer deposits at issue advance payments for service and, therefore, gross income pursuant to I.R.C. § 61? RIRA Nos. 0061.09-01; 0451.13-01
2. Assuming the deposits are advance payments, may inclusion in income be deferred beyond the year of receipt? RIRA Nos. 0451.12-01; 0451.13-03
3. If the deposits at issue are advance payments, may adjustments to income be reduced by certain income previously accrued for services rendered? RIRA No. 0451.13-00
4. Is the recharacterization of customer deposits as advance payments a change in method of accounting pursuant to I.R.C. §§ 446 and 481? RIRA Nos. 0446.04-01; 0481.00-00

CONCLUSIONS

1. The customer deposits are advance payments for telephone services and, therefore, constitute taxable gross income pursuant to I.R.C. § 61.
2. Because the deferral of inclusion of the advance payments in income beyond the year of receipt is not available pursuant to any of the theories discussed by [REDACTED], such payments are taxable income in the year of receipt.

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3. There is no double counting of income as alleged by [REDACTED] because the services to which the customer deposits are attributable are undetermined when the advance payments are made. Therefore, adjustments to income need not be reduced by income previously accrued.
4. The recharacterization of customer deposits as advance payments involves the proper time for reporting income and is a change in method of accounting subject to the approval of the Commissioner.

FACTS

The dispute in this case concerns the [REDACTED] notice of deficiency which was mailed to [REDACTED], as common parent of an affiliated group of [REDACTED] in which customer deposits for taxable years [REDACTED] and [REDACTED] were included in gross income and such inclusion was treated as a change in method of accounting under I.R.C. § 481. [REDACTED] uses the accrual method of accounting for regulatory, financial and tax reporting purposes.

[REDACTED] obtained customer deposits from applicants for telephone service who were unable to demonstrate creditworthiness and from existing customers who consistently failed to pay their bills when due. Upon payment of the deposit, the customer was generally furnished with a deposit receipt, and interest at prescribed rates accrued on deposits held by [REDACTED]. According to [REDACTED], the purpose of the "customer security deposits" was to provide security (in the nature of a cash bond) for performance by noncreditworthy customers. [REDACTED] states that the "customer security deposits" were not intended, used or treated as advance payments for telephone services. In essence, [REDACTED]'s overall argument is that the character of the deposits is as security for potential noncreditworthy performance by customers.

[REDACTED] generally refunded deposits as soon as creditworthiness was demonstrated or when service was terminated, whichever occurred earlier. Deposits were refunded by check or by offset to the customer's bill when bills had been paid regularly for a prescribed period after the deposit was collected. The prescribed period was generally between nine and twelve months for both residential and business customers, but in some states, the period was between two and three years for business customers.

█████ bills all customers monthly for the following month's basic service plus any long distance service charges incurred during the preceding month and income is accrued pursuant to Bills sent to all customers throughout the year. Pursuant to the FCC Uniform System of Accounts and the regulations of the state public utility commissions, customer deposits are considered current liabilities and are required to be characterized and accounted for as such, and not as income.

█████ notes that the treatment of customer deposits as liabilities is in accord with generally accepted accounting principles, has been universally accepted by the telephone industry, and has been consistently utilized for tax and financial accounting purposes. 1/

1/ In their discussion of the legal issues, █████ does not again refer to this point. We note that it is well established that reasonable financial accounting methods often may not be acceptable for tax purposes; to say that a taxpayer's accounting practice "is in accord with generally accepted commercial accounting principles" ... is not to hold that for income tax purposes it so clearly reflects income as to be binding on the Treasury." American Automobile Ass'n v. United States, 367 U.S. 687, 693 (1961) (footnote omitted). The Court recently reconfirmed and elaborated upon this proposition, emphasizing "the vastly different objectives that financial and tax accounting have." Thor Power Tool Co. v. United States, 439 U.S. 522, 542 (1979). The primary goal of financial accounting is to provide useful information to management, shareholders, [and] creditors" and thereby "to protect these parties from being misled." Id. Moreover, "financial accounting has as its foundation the principle of conservatism, with its corollary that 'possible errors in measurement [should] be in the direction of understatement rather than overstatement of net income'" (Id., quoting AICPA Accounting Principle Board, Statement No. 4, Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises para. 171 (1970)). Therefore, "accounting principles typically require that a liability be accrued as soon as it can reasonably be estimated" (439 U.S. at 543 (footnote omitted)). By contrast, "[t]he primary goal of the income tax system ... is the equitable collection of revenue; the major responsibility of the Internal Revenue Service is to protect the public fisc" (Id. at 542), these missions plainly are incompatible with a system skewed toward understatement of income. Thus, the Court concluded, "[g]iven this diversity, even contrariety, of objectives, any presumptive equivalency between tax and financial accounting would be unacceptable." (Id. at 542-43 (footnote omitted)).

DISCUSSION

I. Are the customer deposits at issue advance payments for service and, therefore, gross income pursuant to I.R.C. § 61?

█████'s position is that the refundable "customer security deposits" do not constitute gross income to the telephone companies, but █████ admits that if the customer deposits are advance payments for future telephone services, they do constitute gross income to the companies. █████ relies heavily on Illinois Power Co. v. Commissioner, 792 F.2d 683 (7th Cir. 1986), in which the Seventh Circuit held that certain revenues collected in payment for electricity and held pending a subsequent order by the Illinois Commerce Commission to refund such revenues, did not constitute taxable income. █████ also cites James v. United States, 366 U.S. 213, 219 (1961), for the proposition that an amount received with the consensual recognition, express or implied, of an obligation to repay, is not includible in gross income. █████ argues that the deposits at issue were collected subject to an unconditional obligation to repay and without any possibility of the companies realizing a permanent benefit from the deposits; therefore, under the principles of Illinois Power and James, the deposits are not taxable income in the year of receipt.

█████ also discusses City Gas Co. of Fla. v. Commissioner, 74 T.C. 386 (1980), rev'd and rem'd, 689 F.2d 943 (11th Cir. 1982), on rem'd, T.C.M. 1984-44, 47 T.C.M. (CCH) 971 and Gas Light Co. of Columbus v. Commissioner, T.C.M. 1986-118, and attempts to distinguish the deposits in those cases from the deposits at issue. Lastly, the two memoranda argue that United States v. Hughes Properties Inc., 106 S.Ct. 2092 (1986), compels the conclusion that if the deposits are advance payments constituting income upon receipt, █████ is entitled to accrue a deduction for the obligation to refund such deposits.

Service position on customer deposits may be summarized as follows:

The taxability of customer telephone deposits pursuant to sections 61, 451 and 446 is dependent upon resolution of the question of whether the amounts received are nontaxable security deposits or advance payments of income. In situations where the purpose of the "deposit" is to secure the payment of future income, it is properly treated as an advance payment of income City Gas Co. of Fla. v. Commissioner, supra; Van Wagoner v. United States, 368 F.2d 95 (5th Cir. 1966).

Revenue Ruling 72-519, 1972-2 C.B. 32, sets forth examples on whether amounts received by a water utility are security deposits or advance payments for goods and, if advance payments, when they are includible in income. The conclusion reached in the revenue ruling is that amounts received to guarantee the

payment for services or goods provided by the utility company are advance payments. Situation 1 of Rev. Rul. 72-519, supra, concludes that amounts received from customers to protect the taxpayer's title to and interest in its property are nontaxable security deposits and not advance payments. In Situation 2 of the revenue ruling amounts intended to guarantee the customer's payments of the amount due for goods are treated as advance payments for those goods rather than security deposits.

Where the purpose of the purported "deposit" is to secure the payment of future income or to act as a prepayment for goods or services, it is treated as an advance payment of income. Van Wagoner v. United States, supra; City Gas Co. of Fla. v. Commissioner, supra. Where, however, the purpose of the "deposit" is to secure the utility's property interests or to secure the performance of conditions or other nonincome-producing covenants, the payment is regarded as a nontaxable security deposit. See Rev. Rul. 72-519. Accordingly, if the "deposit" can be applied to the customer's bill for gas or electricity, or for turn-on and turn-off charges or for any other charges for services, it is an advance payment of income. Likewise, if the amount is to guarantee payment of bills, to provide a security for accounts receivable owed by customers, or to protect against loss of revenue, it is income when received. See Commissioner v. Lyon, 97 F.2d 70 (9th Cir. 1983); Gilken Corporation v. Commissioner, 10 T.C. 445 (1948), aff'd, 176 F.2d 141 (6th Cir. 1949); City Gas Co. of Fla., supra. If the purported "deposit" serves both purposes, then a determination must be made whether, under all the circumstances, its primary purpose is to prepay income items or to secure property. City Gas Co. of Fla., supra.

Where an amount has been received under a present claim of full ownership subject to a taxpayer's unrestricted control, it is income in the year of receipt, even though a refund may be made under certain circumstances. Brown v. Helvering, 291 U.S. 193 (1934); Commissioner v. Lyon, supra; Mantell v. Commissioner, 17 T.C. 1143 (1952). Hirsch Improvement Co. v. Commissioner, 143 F.2d 912, 916 (2nd Cir. 1944). The possibility that a payment will be refunded is not, therefore, a controlling factor to determine whether it is a nontaxable security deposit. See August v. Commissioner, 17 T.C. 1165 (1952), for example, in which amounts were considered advance payments rather than nontaxable security deposits even though the "deposit" was to be returned simultaneously with the return of the leased property if the lessee had complied with the terms of the lease including the payment of rent. In that case, the purpose of the "deposit" was to guarantee the receipt of future income. The fact that interest may be required to be paid on the "deposit" does not alter this determination. Deposits received by telephone companies are deemed to be advance payments for services and are treated for tax purposes according to the provisions of Revenue Procedure 71-21, 1971-2 C.B. 549, to be discussed infra.

Reconsideration of Revenue Ruling 72-519-Income Tax Treatment of Customer Deposits, G.C.M. 37032, I-632-73, (March 7, 1977), determined that in characterizing a deposit as an advance payment for goods and services, there is no meaningful distinction between money currently received that must be applied to a future period's bill and money currently received that must be refunded at some future time because a customer has paid all obligations. Accordingly, the G.C.M. concludes that a deposit that is intended to assure that the customer pays for goods or services should be treated as an advance payment for such goods or services whether or not it is refundable at the termination of the contract between customer and taxpayer or at some specified time prior to such termination.

A. Illinois Power Co. v. Commissioner

█████ argues that Illinois Power Co. v. Commissioner, 792 F.2d 683 (7th Cir. 1986), reaffirms the basic principle that money received under an unequivocal contractual, statutory, or regulatory duty to repay is not properly includible in income. The excess charges at issue were collected as electricity payments. Even though the utility was not ordered to refund the excess charges until five years after collection, the Seventh Circuit concluded that the excess charges were not includible in income upon receipt because the state public utility commission had authorized the charges solely to encourage commercial customers to consider switching to alternative sources of energy. The charges were not intended to provide a permanent benefit to the utility, and the commission intended to order the utility to refund the charges at an appropriate time. Unlike advance payments for goods and services, █████ argues, where the purpose of the payment is to secure the payor's good behavior, the payment is not properly includible in income.

In our view the law of Illinois Power (IP) is that funds are taken into income if the recipient's obligation to repay them is contingent, 792 F.2d at 689, whereas funds are not income if the recipient has an unequivocal contractual, statutory, or regulatory duty to repay. Id. The Seventh Circuit found that the commission-ordered rate increase was intended to alter customer behavior, and the order made clear that IP would not be able to keep the money collected. Id. at 688. In an effort to build on this rationale, █████ argues in their memo that where the purpose of a payment is to secure the payor's good behavior, the payment is not properly includible in income. This statement, of course, is a minor factual aspect of the Illinois Power decision and is therefore misleading. In any event, █████'s deposits are distinguishable from the IP payments in which the refunds, when subsequently ordered five years later by the commission, did not get disbursed to the same customers who paid the original charges, a result which militates against viewing them as advance payments by particular customers. In contrast, the █████ deposits, security for nonpayment by customers and therefore advance payments, if refunded at all, would be refunded to the customer who made the advance payment.

The court viewed IP as a custodian, with no greater beneficial interest in the revenues collected than a bank has in money deposited with it. Id. at 689.

██████ also argues that their deposits, like the IP payments, were for behavior inducement (creditworthiness) and not prepayment for telephone services, and the deposits were not income because they would be refunded as soon as creditworthiness was established. It is our position that the ██████ deposits unequivocally secure the payment of future income and thus have an economic purpose and constitute an economic benefit to the companies. ██████ is not attempting solely to modify behavior like the commission in IP.

The court found in Illinois Power that the refund obligation was not contingent, but rather was an unequivocal duty to repay money held as a custodian. Id. at 689. In contrast, ██████ is not a mere custodian, but has collected deposits for its own protection and benefit (advance payments), and the refund obligation is contingent upon the customer establishing a satisfactory credit history.

An instructive case is Nordberg v. Commissioner, 79 T.C. 655 (1982), aff'd without opin., 720 F.2d 658 (1st Cir. 1983), which was cited with favor by the Seventh Circuit in Illinois Power, 792 F.2d at 689, for the proposition that where taxpayer's obligation to refund money that he has received is contingent, the money is taxable income. In Nordberg, taxpayer agreed to refund the full amount of a partial payment of a subordinated note, but any such refund was contingent on the future assertion of prior adverse claims. No provision was made for repayment, and the assertion of a prior claim might never occur. The court, citing North American Oil Consolidated v. Burnet, 286 U.S. 417 (1932), held that the taxpayer received income under a claim of right without any restriction on disposition notwithstanding a contingent obligation to return the payment at a later time.

It is our opinion that the contingencies affecting ██████'s refund obligation are analogous to the contingencies in Nordberg. As the court stated, 79 T.C. at 665, the mere fact that income received by a taxpayer may have to be returned at some later time does not deprive it of its character as taxable income when received. To avoid application of the claim of right doctrine, the recipient must at least recognize in the year of receipt an existing and fixed obligation to repay the amount received and make provisions for repayment; a contingent obligation to repay is insufficient. Id.

The Seventh Circuit in Illinois Power also cited Mutual Telephone Co. v. United States, 204 F.2d 160 (9th Cir. 1953), as indistinguishable from Illinois Power but which we submit is quite distinguishable from the ██████ facts. In Mutual Telephone, the Ninth Circuit held that a rate increase was not gross income

to the utility when received. The Public Utility Commission approved a rate increase in an effort to reduce demand for new telephone service. The Commission ordered that the increase was not to be taken into income until so authorized. Because the Commission and not Mutual controlled disposition of the funds, and because Mutual did not have unrestricted freedom to enjoy the receipts at its option, 204 F.2d at 161, the receipts were held not to be taxable income. Illinois Power, of course, also involved a commission-ordered rate increase to induce conservation by ratepayers. The funds were held by IP as a custodian for the ratepayers pursuant to an unequivocal duty to repay as established by the Commission order. 792 F.2d at 688-89. In contrast, [REDACTED] is in receipt of payments for service under a claim of right, and such payments are subject to a contingent obligation of refund if the customers maintain a satisfactory payment record.

[REDACTED], in their supplemental memo at 3 and 4, distorts both the law and the facts in analyzing their deposits. With regard to the facts, they allege that the deposits at issue were subject to an "unconditional obligation to repay." Rather, the deposits were collected as security for receipt of future payments for services and as such are properly treated as advance payments and taxable income. The refund obligation was contingent (conditioned on creditworthiness), and there was a possibility the deposits would be applied to customer accounts rather than refunded. [REDACTED] alleges that "funds collected subject to an obligation to repay, under whatever circumstances, do not constitute taxable income." This distortion and gross simplification of the claim of right doctrine is demonstrated by an authority cited in Illinois Power, a case which [REDACTED] cites with favor and erroneously believes supports its position. The Seventh Circuit, 792 F.2d at 689, cites Dubroff, The Claim of Right Doctrine, 40 Tax L. Rev. 729 (1985), with reference to the taxability of income received under a contingent obligation to refund. Professor Dubroff, at 741-42, states that taxation is not generally deferred by the obligation to repay. Although a taxpayer may feel constrained as to the disposition of funds received under a claim of right because of the possibility that he may later be required to return those funds, this is not a sufficient restriction upon disposition as to prevent current taxation.

We note that the Illinois Power decision is in accord with the analysis found in [REDACTED], G.C.M. 38553, I-458-78, (October 30, 1980), which also supports the taxability upon receipt of the [REDACTED] deposits. The G.C.M. concludes that mandatory contributions by employees to an executive security plan, under which the employer must pay to the employees' estates or beneficiaries no less than the amount contributed, are analogous to refundable deposits and are not includible in the gross income of the employer. The G.C.M. reasons, at 5, that "if the mandatory payments are, in fact, refundable in all circumstances, [absolute requirement of repayment] and if there

is no permanent economic benefit accruing to the company (other than the temporary use of the money) from these contributions, then we see no conclusion under accepted law other than that these payments are closely enough analogous to loans or deposits as to be excludible from income; if, on the other hand, the payments are made as part of a sale of services, a promise to perform, or other valuable rights, we would have to agree that the payments should be taken into income." With [REDACTED] not only are the deposits received for services, but there is no absolute requirement for repayment.

B. James v. United States

[REDACTED]'s reliance on James v. United States, 366 U.S. 213 (1961), is misplaced. In James, the taxpayer had been convicted of willfully attempting to evade federal income tax for failure to report amounts embezzled from his employer. In holding that embezzled money is taxable income to the embezzler, the Court announced a control test as follows:

A gain constitutes taxable income when its recipient has such control over it that, as a practical matter, he derives readily realizable economic value from it When a taxpayer acquires earnings, lawfully or unlawfully, without the consensual recognition, express or implied, of an obligation to repay and without restriction as to their disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent. ... In such case the taxpayer has actual command over the property taxed - the actual benefit for which the tax is paid.

Id. at 219.

[REDACTED] distorts and reverses the meaning of this holding in their memorandum at 8, by stating that the Supreme Court made clear in James that "an amount received with the consensual recognition, express or implied, of an obligation to repay, is not includible in gross income." (emphasis added). They argue that loans are such nontaxable funds, and then allege that the deposits at issue (presumably like loans) were received with the consensual recognition of an obligation to repay, and are not taxable advance payments.

It is undisputed, of course, that loans do not constitute taxable income, but [REDACTED] stretches credibility by implying that their deposits are similar to loans. The converse of the Supreme Court holding in James as espoused by [REDACTED] that is, a recognition of an obligation to repay certain funds precludes

the inclusion of such funds in gross income is not the law. Not only is [redacted]'s obligation to repay the deposits a contingent obligation, but the Supreme Court clearly articulated in James that even though a taxpayer may later be required to repay funds, the actual command over the property requires inclusion in taxable income. Id. at 219. Advance payments or deposits intended to secure future services, even though refundable under some circumstances, are includible in gross income. See Angelus Funeral Home v. Commissioner, 47 T.C. 391 (1967), aff'd, 407 F.2d 210 (9th Cir.), cert. denied, 396 U.S. 824 (1969), acq. 1969-2 C.B. 20. See also Schlude v. Commissioner, 372 U.S. 128, 130 (1963). [redacted] is wrong when it states that a recognition of an obligation to repay is sufficient to avoid taxation; rather, the repayment requirement must not be subject to any contingencies, i.e., payments must be refundable in all circumstances. See Fisher v. Commissioner, 54 T.C. 905 (1970).

C. City Gas Co. of Florida v. Commissioner; Gas Light Co. of Columbus v. Commissioner

The bellwether standard, in a utility case context, for determining the taxability of customer deposits is the "primary purpose" test set out by the Eleventh Circuit in City Gas Co. of Fla. v. Commissioner, 689 F.2d 943 (11th Cir. 1982), on remand, T.C.M. 1984-44. The court stated that if the primary purpose of a payment is an advance payment for goods and services, even though a refund may be required under certain circumstances, the amount constitutes taxable income; but if the primary purpose is to secure against damage to property or to secure the performance of nonincome-producing covenants, the payment is a nontaxable security deposit. Both City Gas on remand and Gas Light of Columbus, T.C.M. 1986-118, applied the "primary purpose" test and found the customer deposits to be taxable advance payments. [redacted] focuses on illusory or irrelevant distinguishing features of these two cases in an effort to bring the telephone deposits at issue outside their scope. 2/

2/ [redacted]'s analysis of City Gas and Gas Light is unclear with regard to the relationship of these cases to James v. United States. See [redacted] memo at 9, where it states that the Eleventh Circuit primary purpose test "improperly extends the sweep of the prepayment doctrine so as to directly conflict with the clear principles articulated in James" and that although the Tax Court did not specifically address the applicability of James, "the ultimate conclusion reached by the Tax Court in each of these cases is not necessarily inconsistent with James." In any event, as discussed, supra, we disagree with [redacted]'s belief that James, a case involving the taxability of embezzled funds, has anything but tangential relevance to customer deposits. Supreme Court cases more on point involve the current taxability of amounts received for future services. See Schlude v. Commissioner, 372 U.S. 128 (1962); American Automobile Association v. United States, 367 U.S. 687 (1960); Automobile Club of Michigan v. Commissioner, 353 U.S. 180 (1957).

██████ tries to distinguish City Gas and Gas Light, memo at 9-10, by emphasizing both a requirement for security deposits to be paid by all customers and the practice that deposits were applied toward payment of customer's final bills. Not only are these distinctions not completely accurate, but they are irrelevant with regard to the "primary purpose" test. First, in City Gas, the Florida Public Service Commission rules stated that the deposit was intended to guarantee payment of bills and utilities and could provide for return of deposits after a reasonable period of time. The receipt issued to customers upon payment of the deposit indicated that the deposit was subject to refund at the election of the company prior to service discontinuance. The court noted that the deposit was "generally" applied to a final bill. 689 F.2d at 944-45. In Gas Light, deposits were not required of all customers, only those without an established credit record, and deposits were subject to refund after 24 months of prompt payments.

City Gas, rather than being distinguishable as ██████ alleges, actually involved parallel arguments to those now posed by ██████ and which were disposed of by the Tax Court. In their memo, at 4, ██████ states that the purpose of the customer security deposits was to provide taxpayers with security (in the nature of a cash bond) for performance by noncreditworthy customers and not intended, used or treated as advance payments for telephone services. In City Gas, T.C.M. 1984-44, 47 T.C.M. (CCH) at 973, the court notes that the petitioners argue that their primary purpose in requiring deposits was not to collect an advance payment for goods and services, but to minimize collection losses and to provide security for accounts receivable owed by customers. They argued that they had no purpose, primary or otherwise, to have deposits serve as prepayments for income items. The court pointed out that the petitioners' attempt to distinguish between deposits which pay income items and deposits which merely secure the later payment of such items was not a recognizable distinction under the Eleventh Circuit's "primary purpose" test in which deposits must be categorized as either prepayments for goods and services or as security for the performance of nonincome-producing covenants.

Ironically in Gas Light, T.C.M. 1986-118, taxpayers attempted to distinguish City Gas, and the facts of Gas Light are synonymous with those of ██████. The taxpayers argued that unlike City Gas, deposits were only required of customers without established creditworthiness, deposits were retained only until creditworthiness was established and applied to bills in only a minority of cases, and deposits had to be refunded at the latest after 24 months of prompt payment. On facts so similar to ██████, the court applied the "primary purpose" test and found that the deposits were taxable advance payments.

In summary, in applying the "primary purpose" test and although ██████ contends otherwise, it is not dispositive that deposits are collected only from certain customers to secure

payment of bills until creditworthiness has been demonstrated. [REDACTED] also implies, memo at 11, that all deposits were refunded ("since such refunds were in fact made"). This is an overstatement because some deposits were applied as offsets to bills (indisputably reflecting their status as payment for services) rather than refunded directly to the customer by check. 3/

D. Accruing the Obligation to Refund Deposits

[REDACTED] argues that United States v. Hughes Properties, Inc., 106 S.Ct. 2092 (1986), compels the conclusion that if the deposits are included in income upon receipt, [REDACTED] is entitled to immediately offset such income by accruing a deduction under section 461 for the obligation to refund the deposits. Such a position not only incorrectly applies the "all events" test but misconstrues the Hughes holding.

The all events test of Treas. Reg. § 1.461-1(a)(2) provides that an accrual basis taxpayer may accrue expenditures in the taxable year in which all the events have occurred which determine the fact of liability and the amount can be determined with reasonable accuracy. In Hughes Properties, not only did state law create an irrevocable liability, but the obligation amount was fixed at year end. The taxpayer accrued the amounts shown as jackpot payoff amounts on the slot machines on the last day of the fiscal year. In contrast, the refund obligation at issue here is contingent on possible future events - establishment of creditworthiness, voluntary termination of service or involuntary termination of service due to non-payment. In addition, because the time when a refund obligation may arise is unknown, should a refund occur, the amount is uncertain because the amount of interest due is a

3/ [REDACTED] memo at 8 n. 3, argues that Boston Consolidated Gas Co. v. Commissioner, 128 F.2d 473 (1st Cir. 1942), supports their position that customer deposits are not advance payments at the time of receipt. We note that the Eleventh Circuit in City Gas, 689 F.2d at 948-49, properly dealt with the significance of Boston Consolidated. In Boston, unclaimed deposits not previously included in income were transferred to a profit account, and the Commissioner argued that they were taxable upon such transfer. The Boston court was not presented with the argument that deposits could be taxable income during the time they were treated as liabilities for accounting purposes; the court, therefore, did not consider the argument that deposits which are primarily related to payment of income items are taxable income, notwithstanding the accounting treatment as liabilities. This case, of course, does not represent current Service position.

function of interest rate (which is fixed) and time held (which is unfixed). Also, unlike Hughes, the general obligation, pursuant to state tariffs, to refund deposits does not fix the liability to refund because all such advance payments are not refunded and thus would never give rise to a deduction.

It is our position that accruing an obligation to refund the deposits at issue, as proposed by [REDACTED], would be a premature accrual. [REDACTED]'s Supp. Memo at 6 states "When the right number of payments was made, the deposit would be refunded." This statement ignores the possibility of the deposit being applied as an offset to a bill for telephone services, and an offset is not an accrued liability to refund the deposit. Deposits which are applied to customer bills, either upon voluntary cessation of service or upon default in payment, are not properly treated as deductions; rather, they are advance payments, previously taken into income and now applied to the customer account. The proper treatment of such deposits may be illustrated by three examples:

1. Year 1 - \$50 deposit accrued as advance payment.
Year 2 - Service terminates; final bill is \$80; \$50 advance payment applied as offset; accrue \$30 balance as income.
2. Year 1 - \$50 deposit accrued as advance payment.
Year 2 - Service terminates; final bill is \$30; \$50 advance payment applied as offset; \$20 balance refunded to customer and taxpayer takes \$20 deduction for the repayment.
3. Year 1 - \$50 deposit accrued as advance payment.
Year 2 - Creditworthiness established; deposit refunded by check; taxpayer takes deduction for repayment amount.

As a final point, we note an analogous case in which a premature accrual of obligations to refund deposits was denied because the obligation to refund was contingent on future events. In Nesbit Distributing Co. v. United States, 604 F.Supp. 552 (S.D. Iowa 1985), taxpayer had a statutory obligation to refund deposits for each beverage container returned for redemption in later years. Taxpayer considered its obligation to refund deposits on certain containers an accrued liability and did not include such funds in taxable income. Taxpayer estimated the percentage of containers which would be redeemed for deposits. The court agreed with the Commissioner that the "all events" test was not satisfied; taxpayer's liability to refund the deposits was contingent on future events, i.e., the return of containers to redemption centers.

II. Assuming the deposits are advance payments, may inclusion in income be deferred beyond the year of receipt?

██████ argues that even if the customer deposits are properly includible in income, such inclusion should be deferred beyond the year of receipt until the year in which telephone services purchased with the deposits are supplied or deferred in accordance with either Treas. Reg. § 1.451-5(c) or Rev. Proc. 71-21, 1971-2 C.B. 549.

Rev. Proc. 71-21 provides procedures under which accrual method taxpayers may, under certain circumstances, defer the inclusion in income of payments received in one taxable year for services to be performed in the next succeeding taxable year. Such payments, received in one taxable year for services to be performed by the end of the next taxable year, may be included in income in the year earned through the performance of services. Deposits received by telephone companies are deemed to be advance payments for services and are treated for tax purposes according to the provisions of Rev. Proc. 71-21. Section 3.03 of this revenue procedure states:

a payment received by an accrual method taxpayer pursuant to an agreement for the performance by him of services must be included in his gross income in the taxable year of receipt if under the terms of the agreement as it exists at the end of such year ... (b) any portion of the services is to be performed by him at an unspecified future date which may be after the end of the taxable year immediately succeeding the year of receipt.

Accordingly, where agreements relating to deposits received by telephone companies lack specificity as to when the services will be rendered, the deposits do not qualify for deferral pursuant to Rev. Proc. 71-21, and the deposits are includible in income in the year of receipt.

A. Defer Accrual of Deposit Income Until Services Rendered

██████ argues, memo at 18, that each deposit serves as a prepayment for the current month's services and "rolls forward" as a prepayment as successive monthly bills are paid. In accordance with this view, their position is that for year end deposits (rolling deposits) serving as prepayments for the first services to be rendered in the succeeding year, inclusion in income must be deferred until such services are rendered in the succeeding year. They cite with favor Boise Cascade Corp. v. United States, 530 F.2d 1367 (Ct. Cl.), cert. denied, 429 U.S. 867 (1976) and Artnell Co. v. Commissioner, 400 F.2d 981 (7th Cir. 1968).

In Artnell, taxpayer was allowed to defer inclusion in income of payments received in one taxable period for services to be performed in the next taxable period. Since the taxpayer in Artnell would be permitted to defer the inclusion of advance payments in income until the following year pursuant to Rev. Proc. 71-21, the Service did not consider the court holding erroneous; however, the Service will not follow Artnell to the extent the rules for deferral set out by the court could be deemed to be broader than those contained in Rev. Proc. 71-21. Artnell Co. v. Commissioner, A.O.D. (July 27, 1971). In Artnell, the advance receipts were for the upcoming baseball season; therefore, the time for performance of services was definitely the succeeding taxable year and fit within the scope of Rev. Proc. 71-21. The [REDACTED] deposits are not designated or attributable to any certain period of time and are distinguishable from the deferred payments in Artnell.

The Service disagrees with the Boise decision. Boise Cascade Corp. v. United States, A.O.D. 13775 (Feb. 19, 1986). The court concluded that unearned payments received by taxpayer were not includible in income in the year received because taxpayer's contractual obligation to provide future services was fixed and definite and thus permitted income deferral under a clear reflection of income standard. The court's decision was not based on Rev. Proc. 71-21. The Service, in addition to relying on Supreme Court cases involving deferred recognition of income, also took the position that the rules of Rev. Proc. 71-21 for income deferral were not met because the contracts for performance of engineering services did not uniformly fix an exact date for such performance. 530 F.2d at 1378 fn. 8. 4/

4/ [REDACTED] memo at 18 fn.8 cites Schlude v. Commissioner, 372 U.S. 128 (1963), and states that there is no uncertainty of performance with telephone services in contrast to Schlude, where it was unclear when, if ever, services would be provided. It is our position that the deposits at issue are not attributable to any specific period and for that reason do not meet the deferral rules of Rev. Proc. 71-21. We also note with regard to Schlude, that the issue of when services would be provided was not necessary to the holding that advance payments must be accrued as income. The Court rejected taxpayer's accrual of income which was based on services performed and which deferred accrual of advance payments. The Court required accrual of advance payments received as well as payments which were due and payable.

B. Treas. Reg. § 1.451-5(c)

█████ argues that all types of utilities should be accorded the same treatment with regard to customer deposits under Treas. Reg. § 1.451-5(c). Without presenting a cogent argument that telephone services are inventoriable goods, as required by the regulation, they mention logic and equity in support of their position. ^{5/}

The regulation at issue sets out an exception to the advance payment provisions for inventoriable goods. If a taxpayer receives advance payments under an agreement in one taxable year, advance payments received by the last day of the second taxable year following the year payments are received must be included in income no later than the second taxable year. To fit within this exception, of course, telephone services must be inventoriable goods.

█████ correctly notes that furnishing electricity constitutes the sale of an inventoriable good under Treas. Reg. § 1.451-5(c) rather than the performance of a service. An electric utility manufactures a product termed electricity. The product, electricity, is measured by a unit of power, expressed in watts (normally kilowatts); the watt being the unit that expresses the power of the flow of electrons through an electrical circuit. The product that is manufactured is electrical energy in the form of separated electrons. This remains the product from the time of generation, through transmission, to its final destination. While it is true that, because of the mode of transporting the product, the pressure and rate at which the product is transmitted must be altered, the final product manufactured at the generating plant remains electrical energy. Because electricity which is manufactured in a power plant is produced by the employment of labor and machinery resulting in a consumable product, it should be classified as a "good".

While there is considerable conflict among various state supreme courts, the weight of authority appears to be that the production of electricity by artificial means in a condition fit for use is generally regarded as a manufacturing process rather than a service. Annot. 17 A.L.R.3d 7, 102-103, Annot. 17 A.L.R.3d 7, 104-105, 55 C.J.S. § 4(g) at 693-694. The Supreme

^{5/} █████ memo at 20, does cite Rev. Rul. 83-135, 1983-2 C.B. 149, and states the Service reaffirmed that the provision of telephone service qualifies as the sale of goods for purposes of the patronage dividend provisions (sections 1381-1388). This is a distortion of the ruling which does not say that telephone service involves a sale of goods.

Court of Alabama in the frequently cited case of Curry v. Alabama Power Co., 8 So.2d 521, 243 Ala. 53 (1942), held that the production of electricity by the operation of an electric power plant constituted manufacturing within the meaning of a use tax statute exempting from the operation thereof certain articles purchased for use in the manufacturing of tangible personal property. The court stated that

the proof and scientific facts, sustain the claim of tangibility. The proof shows that electricity consists of negative electrons. Electrons have mass or weight. Electricity can be tasted. It can be detected by the sense of smell. It can be perceived by touch. A sufficient charge will tear a hole in the body as it enters and as it leaves.... The flow of electrons is substantially the same as the flow of water.

We conclude, therefore, that appellant is engaged in manufacturing tangible personal property. Id. at 526.

Similarly, the Supreme Court of Minnesota held that production of electricity constituted manufacturing within the meaning of its use tax statute. Minnesota Power & Light Co. v. Personal Prop. Tax, Taxing Dist. 289 Minn. 64, 182 N.W. 2d 685 (1970). The court stated "[t]hus, in the language of everyday life and in the strictly commercial sense of the term, 'electricity' is 'produced', 'stored', 'measured', 'bought and sold'. It is moved or transported from place to place in containers or by cable. ... Brought into being as a product, it exists in modern life as a commodity." Id. at 691 quoting Spillman v. Interstate Power Co., 118 Neb. 770, 226 N.W. 427, 433.

Because electricity made or produced by artificial means is classified as personal property or a product, it should be considered a "good" rather than a service for federal tax purposes. In addition, availability rather than attributes of storage, enumerability or measurability bring electricity within the regulation requirement of goods properly includible in inventory. Treas. Reg. § 1.451-1(c)(1)(i).

With regard to gas utilities, the Tax Court in City Gas Company of Florida v. Commissioner, T.C.M. 1984-44, held that "utility deposits" constituted substantial advance payments for inventoriable goods and, as such, were includible in income no later than the last day of the second taxable year following the year of receipt. Taxpayer in that case argued that the regulations' treatment of advance payments for inventoriable goods did not apply because it had no inventory. As set forth in the findings of fact, City Gas had no storage facilities. The gas was delivered directly from its supplier to its

customers. The court stated "[t]here is no question, however, that the gas purchased by City Gas would have been 'properly includable' in inventory had such an account been maintained", citing Treas. Reg. § 1.471-1, making use of inventories mandatory for all business in which "the production, purchase, or sale of merchandise is an income-producing factor." "The gas was, therefore, 'properly includable' in inventory even though the speed with which it was turned over made the maintenance of an inventory account unnecessary." City Gas, T.C.M. 1984-44, 47 T.C.M. (CCH) at 978.

Current Service position does not regard the provision of telephone services as a sale of inventoriable goods. Telephone services are not analogous to a manufactured product like electricity (an electric company can and does purchase excess electricity from others when needed to cover its peak usage periods), nor may they be viewed as inventoriable goods like gas.

██████ incorrectly alleges that some state supreme courts have held that electronic transmissions are goods. They first cite State v. Television Corp., 271 Ala. 9, 127 So.2d 603 (1971). In that case, the court first held that electricity is tangible personal property and accordingly, television power amplifiers were machines used in processing electricity and were therefore machines used in processing tangible personal property. Tabulating Service Bureau Inc. v. Commissioner of Taxation, 295 Minn. 562, 204 N.W. 2d 442 (1973), involved whether taxpayer's computer equipment produced a product or a service for customers. The Commissioner of Taxation believed that taxpayer performed a service. The court held that the processing of customer data by the computer machines involved an action or operation which produced a product in the form of various reports and printouts. Similarly, Northwest Optimization Service, Inc. v. County of Hennepin, 295 Minn. 570, 204 N.W. 2d 640 (1973), held that the operation of taxpayer's computer system which placed printed and written information on magnetic tapes for further use by customers or which produced printouts, constituted a marketable product.

C. Rev. Proc. 71-21, 1971-2 C.B. 549

██████ disagrees with the analysis of Rev. Proc. 71-21 and telephone customer deposits found in Ltr. Rul. 8027012, March 26, 1980. ██████ disagrees that their deposits secure payment for services at an unspecified future date. Rather, they argue that the deposits secure payment for the first service rendered after the deposits are received, and they secure payment of the succeeding months' services on a rolling basis throughout the creditworthiness period. In other words, their position is that the deposits protect the company from the risk of nonpayment for the first service rendered. Service position is that the telephone customer deposits secure payment for an unknown, future month of nonpayment. ██████ again tries to distinguish

City Gas by stating that the deposits there did not relate to the first service rendered but provided protection for the final bill, to avoid a customer leaving the area without settling his account. We believe such a distinction is immaterial for purposes of applying Rev. Proc. 71-21. In City Gas, it could not be predicted which month would be the final billing month; the [REDACTED] deposits secure against future nonpayment and it is unknown when nonpayment may occur. 6/ More importantly, the City Gas advance payments were for inventoriable goods rather than services and were accrued pursuant to Treas. Reg. § 1.451-5(c).

In summary, [REDACTED] believes that pursuant to Rev. Proc. 71-21 and a rolling deposit analysis, year-end deposits are properly included in income in the succeeding year.

Ltr. Rul. 8027012 is an example of Service position with regard to Rev. Proc. 71-21 and its applicability to telephone customer deposits. The ruling provides:

[P]ayments received by an accrual method taxpayer in one taxable year for services to be performed by the end of the next succeeding taxable year may be included in income in the year earned through the performance of the services. However, section 3.03(b) of Rev. Proc. 71-21 provides that a taxpayer may not defer advance payments for services if any portion of the services is to be performed at an unspecified future date which may be after the end of the taxable year immediately succeeding the year of receipt.

In the years involved in this case the deposits were refunded only if a customer requested a refund or terminated service. Beginning in 1976, the deposits have been refunded to the customer after 12 consecutive months of prompt payment. However, since the agreement under which the taxpayer holds these deposits does not have a fixed expiration date, and assuming these are advance payments for services to be rendered in the future, it is impossible to determine when the services will be performed. These amounts may be applied against payments for

6/ In addition, the City Gas deposit receipt provided for earlier refund at the company's discretion.

services at any time while they are being held by the taxpayer. Thus, the advance payments may be applied against payments for services after the end of the taxable year immediately succeeding the year of receipt. Accordingly, the deferral rules of Rev. Proc. 71-21 would not apply. The customer deposits are includible in income in the year of receipt.

Even if a telephone company receives deposits under an agreement providing for refunds after a specified number of months of prompt payment, the deferral rules of Rev. Proc. 71-21 would still not be available. Such advance payment deposits secure the payment for services at an unspecified future date. If an agreement requires a specified consecutive number of months of prompt payment before refund will be made, delinquency at any point will presumably begin the time period running again. Therefore, such deposits could be applied as payments for services at any time while being held and would not necessarily be applied to services in the succeeding year. Payments must relate to services to be provided in the succeeding taxable year for deferral of income pursuant to Rev. Proc. 71-21 to be available.

III. If the deposits at issue are advance payments, may adjustments to income be reduced by certain income previously accrued for services rendered?

██████ argues that the customer deposits provide security for nonpayment of the first services rendered and should be treated as income attributable to the first services rendered after receipt. As customer payments are subsequently made for services, the deposit rolls forward throughout the creditworthiness period. Furthermore, if the deposits are treated as advance payment income in the year received, they say companies would be taxed twice because income is also accrued when the customer is billed for services rendered in the same time period. Service position, of course, is that this purported double counting of income does not occur because the services to which the customer deposits are attributable is undetermined when the advance payment is made.

In the ██████ Supplemental Memo. at 10, they use the Service concession discussed in City Gas, T.C.M. 1984-44, 47 T.C.M. (CCH) at 979, to support their argument. ██████ alleges, in

support of their position, that the IRS conceded that income earned in the final billing period would be reduced by the amount of the deposit which had been included in income upon receipt. 7/ They state the concession was made because the deposit would be treated as a taxable advance payment for the final month's gas and to include in income the amount billed for that month would result in double counting of income for the same gas sold. They further indicate that the only difference with the deposits at issue here is that double counting would be at the beginning of the customer relationship, whereas in City Gas, it would occur at the end. This argument, though, starts with an assumption with which we do not agree; namely, that the customer deposits are advance payments for the first month's services.

We submit that there will not be double counting of income with the deposits at issue, any more than there was double counting in City Gas. In City Gas, once the final month of service occurred or the advance payment was otherwise attributed to a specific month's bill, the previously accrued advance payment deposit was either applied as an offset to the bill or refunded, e.g., final bill \$80, \$50 advance payment offset, accrue \$30 income or final bill \$30, \$50 advance payment offset, \$20 refund to customer and taxpayer gets \$20 deduction. 8/

It is our position that the [REDACTED] advance payment deposits should receive exactly the same accounting treatment as the deposits in City Gas, once the particular time period to which the advance payments are attributable is determined.

IV. Is the recharacterization of customer deposits as advance payments a change in method of accounting pursuant to I.R.C. §§ 446 and 481?

[REDACTED] argues that pursuant to Treas. Reg. § 1.446-1(e)(2)(ii)(b), an adjustment that is attributable to the change in the character of an item as opposed to the time when an item of income is to be reported, is not a change in method of accounting. Accordingly, if the customer deposits, which have not previously been included in income but treated as liabilities, must now be included in income, such change is a

7/ As a minor point, we believe that [REDACTED] misconstrues the court's actual language which referred to respondent's concession that petitioner must be allowed a deduction for deposits previously included in income which are subsequently returned to customers. See, e.g., examples 2 & 3, supra at 13. We draw a distinction between a deduction for deposits refunded and deposits applied as bill offsets.

8/ See 47 T.C.M. (CCH) at 972, if the deposit exceeded the charges on the final bill, the customer was issued a check in the amount of the excess.

change in the character of an item and not a change in method of accounting.

In an effort to clarify what constitutes a change in method of accounting, T.D. 7073, 1970-2 C.B. 98, amended Treas. Reg. § 1.446-1(e)(2)(ii), regarding requirements respecting the adoption or change of accounting methods. Treas. Reg. § 1.446-1(e)(2)(ii)(a), as amended provides in part that

[a] change in method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. ... A material item is any item which involves the proper time for the inclusion of the item in income or the taking of a deduction.

Conversely, Treas. Reg. § 1.446-1(e)(2)(ii)(b), as amended, provides that an adjustment of any item of income or deduction not involving the proper timing of an inclusion or deduction is not a change in method of accounting.

Service position is thus that the existence of a timing question is the principal criterion in the definition of a change in method of accounting. The presence of a characterization issue is not determinative if a timing issue is in fact involved. For example, a correction to require depreciation in lieu of a deduction for the cost of depreciable assets which had been consistently treated as an expense in the year of purchase involves the question of the proper timing of an item, and is to be treated as a change in method of accounting, even though a change in character is also involved. All accounting practices which relate to the time when an item should be taken into account are considered accounting methods. See 1970-2 C.B. 98.

██████ cites Underhill v. Commissioner, 45 T.C. 489 (1966), to support its argument that a change in characterization of an item is not a change in method of accounting. In Underhill taxpayer did not report discount income on a cost recovery basis (allowed for speculative obligations) but reported on a pro rata basis (for nonspeculative obligations) and subsequently changed to a cost recovery basis on the strength of a court decision in the year of change. The issue before the court was whether the taxpayer could defer the inclusion in income of all payments on principal until he had recovered his cost or should he include in income a prorata portion of each payment. The determinative factor, of course, was the character of the obligation as speculative or nonspeculative, and the character would determine when the payments should be included in income. Having found that some of the obligations were speculative and properly reportable on a cost recovery basis, the court turned to the issue of whether a change in method of accounting was involved.


The court viewed taxpayer's change in treatment of discount income as a character issue (whether the related obligations were speculative or nonspeculative), and once that determination was made, there was no doubt about the time for reporting income. 45 T.C. at 496-97. Underhill thus involved a correction in characterization of an item of income which was determinative of the timing for inclusion of such income. The distinction between Underhill and the [REDACTED] deposits is that regardless of a change in character from liability to income, a timing issue remains - when are the deposits properly includible in income? As discussed, supra, the existence of a timing question is the principal criterion in the definition of a change in method of accounting, notwithstanding the presence of a characterization issue.

[REDACTED] also attempts to distinguish City Gas on the change of accounting method issue by implying that a timing issue was the only issue involved in City Gas. See memo at 23-24. City Gas's prior treatment of deposits was identical to that of [REDACTED] - they were treated as current liabilities. In fact City Gas argued, as does [REDACTED], that the change effected in their method of accounting for deposits was a characterization not a timing issue. "[T]his case does not involve a question of when a particular item will be included in income, but rather one of whether the item constitutes income at all." 47 T.C.M. (CCH) at 979. The characterization of deposits in accordance with the primary purpose test set out by the Eleventh Circuit in City Gas does not erase the timing issue, see 47 T.C.M. (CCH) at 979. The [REDACTED] deposits as well as the deposits in City Gas involve the proper time for reporting income and, therefore, involve a change in method of accounting subject to the approval of the Commissioner.

If you have any questions concerning this matter, please contact Joyce C. Albro at FTS 566-3521.

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